Internal Revenue Service
memorandum

date: MAY 31 1989

to: Rick Smith
International Examiner

from: Kim A. Palmerino
Special Counsel, International

subject: [redacted] - Form 1120F
Calendar years [redacted] and [redacted]

[redacted] - Form 1040NR
Calendar years [redacted] and [redacted]

Your forwarded transmittal letters, preliminary examination reports and supplemental information concerning the captioned foreign person requesting our views.

The facts gathered to date are as follows:

[redacted] is a Mexican resident who controls the operation of a [redacted] farm in the [redacted] area of Mexico which is operated under the name of [redacted] ([redacted]). The actual ownership of the farm land is split among [redacted] family members because Mexican law does not permit an individual to own more than 100 hectares. [redacted] ([redacted]) is a U.S. corporation organized in the State of Arizona in [redacted]. Its shareholders are as follows:

[redacted]	25 shares
	25 shares
	25 shares
	25 shares
Total	100 shares

All of these shareholders are listed on the Form 1120 income tax returns as living in [redacted], Mexico. [redacted] ([redacted]) and [redacted] ([redacted]) are brothers. [redacted] is [redacted]'s son and [redacted] is [redacted]'s son. [redacted] is the president of [redacted] and [redacted] is the vice-president.

An agreement ("the Agreement") between [redacted] and [redacted] was executed on [redacted] which details the business relationship between the parties. Under the Agreement, [redacted] represents it has control and/or

possession of [redacted] of land and farm properties located near [redacted], [redacted], Mexico and intends to plant, grow, harvest and export into the United States fruits and/or vegetables.

[redacted] agrees to advance to [redacted] funds to cover [redacted]'s pre-harvest expenses which [redacted], in its sole discretion, determines are necessary.

[redacted] agrees to advance additional funds to [redacted] as are mutually agreed upon (by [redacted] and [redacted]) for harvesting, picking, packing, loading and shipping the produce.

All of the above advances are to be charged against [redacted]'s account and repaid to [redacted] from sales receipts of fruit and vegetables sold by [redacted] for [redacted].

Miscellaneous expenses advanced by [redacted] to [redacted] are required to be repaid in full. Any brokerages, commissions at auctions and any expenses paid by [redacted] to anyone in the sale of any produce are handled as an expense of [redacted] and deducted from the liquidation (discussed below) to be made to [redacted].

[redacted] agrees to ship all produce grown exclusively to [redacted] for sale and distribution.

[redacted] shall periodically instruct [redacted] about picking, packing and shipping of the produce so that the best available market price can be obtained.

Once the crops have been delivered to [redacted] in [redacted], Arizona [redacted] is to make its best efforts to sell and distribute the crops on the terms and conditions and at the best prices obtainable as [redacted] considers to be in the best interest of the parties.

[redacted] shall have absolute discretion when, to whom and for what prices the crops shall be sold and shall not be liable for any error in judgement. [redacted] does not guarantee collection of accounts receivable; any such losses are to be borne by [redacted], but [redacted] will exercise reasonable efforts to collect all accounts receivable.

[redacted] shall be paid by [redacted] a commission of [redacted]% of the net sales of produce shipped by [redacted] and sold by [redacted].

[redacted] shall remit on a weekly basis all sums due [redacted] from the sale of [redacted]'s produce.

At the end of the Mexican winter vegetable season, June 30, 1985 or thirty days after the date of the last shipment (whichever is later), [redacted] shall furnish to the grower a detailed accounting of all matters pertaining to the handling, distribution and sale of the produce and advances made by [redacted] to [redacted], indicating all sales and expenses incurred. Any balance found due and owing to [redacted] shall be paid by [redacted] to [redacted].

[redacted] had the right to discontinue the marketing or selling of produce at any time in its sole and absolute judgement it is in the best interest of either [redacted] or [redacted].

The Agreement is to be construed according to the laws of Arizona and any legal action to enforce the Agreement's terms shall be filed and determined in the country of [redacted].

In addition to the Agreement a lease was entered into on [redacted] between [redacted] ("Lessor") and [redacted] ("Lessee"). According to a statement attached to schedule E, Form 1040NR for the calendar year [redacted], the leased property is 100% owned by [redacted] and [redacted], is located at [redacted] and consists of a warehouse, offices and cold rooms.

The lease is for a period of twelve months, beginning [redacted] through [redacted] (sic), [redacted], at the annual rate of $[redacted] plus all rental and transaction privilege taxes, payments of $[redacted] plus applicable rental and privilege taxes to be paid on the first of each month.

The lease appears to be a "triple net" lease because lessee is responsible for repair and maintenance (paragraph 13), taxes (paragraph 16) and insurance (paragraph 19).

On their joint 1040NRs for calendar years [redacted] and [redacted] which were not filed until on or after [redacted], [redacted] and [redacted] made an election under § 871(d). The [redacted] 1040NR indicates a 1040NR was filed by [redacted] and [redacted] for the calendar year [redacted].

Also reported on Forms 1040NR for [redacted] and [redacted] were a partnership loss of $[redacted]. No additional information (i.e., K-1) is contained with respect to these amounts.

Potential Issues

(1) Classification of [redacted]; if a corporation within the meaning of § 7701, (2) the proper accounting period (§ 441) and (3) whether [redacted] is engaged in a U.S. trade or

business [§ 864(b)], (4) if [redacted] is ETB, the amount of effectively connected income [§ 864(c)] and (5) whether [redacted]'s failure to file 1120F precludes deductions [§ 882(c)].

Penalties - Failure to furnish information
§ 6038A(d)
Failure to file - § 6651(a)
Negligence - § 6653(a)
Failure to deposit - § 6656
Substantial understatement - § 6661

Alternatively

[redacted] and [redacted] - Calendar years [redacted] and [redacted]

1) Whether engaged in a U.S. trade or business [§ 864(b)];

2) If ETB, amount of gross income effectively connected to their U.S. trade or business [§§ 871(b), 864(c)];

3) Amount of gross, U.S. source income not effectively connected to their U.S. trade or business [§ 871(a), § 1.871-7];

4) Whether [redacted] and [redacted] are precluded from allowable deductions for failure to file a true and accurate return [§ 874(a)];

5) Whether the filing of Form 1040NR on or after [redacted] is within the time prescribed in subtitle I;

Issue

Whether it is appropriate to treat [redacted] as an association taxable as a corporation within the meaning of § 7701(a)(3)

Answer

Based on the information gathered to date, we advise against classifying [redacted] as an association taxable as a corporation. Instead, we believe your alternative issue, which treats the operations of [redacted] as a schedule C trade or business of [redacted], is a more defensible position.

Discussion

The Service position regarding the classification of a foreign business organization for U.S. tax purposes is set forth in Rev. Rul. 73-254, 1973-1 C.B. 613. Rev. Rul. 73-254 states that the tests and standards which will be applied are those of § 7701 and the regulations. However it is the local law of the foreign jurisdiction that must be applied in determining the legal relationships of the members of the organization among themselves and with the public at large, as well as the interests of the members of the organization in its assets.

Rev. Rul. 88-8, 1988-1 C.B. 433 expands on the premise set forth in Rev. Rul. 73-254. Rev. Rul. 88-8 provides that an entity organized under foreign law cannot be classified for federal tax purposes solely on the basis of the label attached to it by the statute under which it is established, without an inquiry into the legal relationships of the members of the entity as established under applicable local law. The rev. rul. requires applicable foreign statutes and the entity's organizational agreements be examined to determine whether the entity is a corporation.

Next the standards of § 301.7701-2 of the regulations must be applied. No foreign organization or entity is classified as an association unless it has more corporate than noncorporate characteristics.

You state that no information is available in the United States to show whether [redacted] is incorporated under Mexican law. Nor apparently, have we been able to establish the legal relationships of the individual members (the "independent growers") to the [redacted] operation. Absent this information, it is impossible to properly analyze the standards for testing corporate status under § 7701(a)(3) and the regulations.

Your analysis of the tests set forth in § 301.7701-2(a)(1) of the regulations led you to conclude that management is centralized in [redacted]. On this point we have established: (1) that [redacted] is a [redacted]% shareholder and the President of [redacted]; (2) that he signed the distribution agreement for [redacted] and (3) that all funds from the sale of produce are directly under his personal control. (4) In the distribution agreement, [redacted] represents it has possession and control of [redacted] of land. We have no direct evidence concerning [redacted]'s governing body, managing functions or day to day operating decisions.

Regarding the characteristics of continuity of life, free transferability of interests and limited liability there is insufficient evidence.

Accordingly, absent further development of the facts, we do not feel we can sustain the 1120F issue. As a result, potential issues 2-5 and the penalties relating to [redacted] are moot.

[redacted] and [redacted] - Form 1040NR
TYE 12/31/[redacted] and 12/31/[redacted]

The [redacted] 1040NR of [redacted] and [redacted] was filed on or after [redacted]. The return contains two items on Schedule E, gross rents of $[redacted] and a partnership loss of $[redacted]. Attached to Schedule E is what purports to be a § 871(d) election. The 1040NR was filed well after Phoenix began its examination of [redacted]. No mention of [redacted] appears on the return and no income attributable to [redacted]'s U.S. sales of produce is reported.

Issue 1

Is [redacted] engaged in a U.S. trade or business within the meaning of § 864(b).

Answer

Yes. By virtue of the regular and continuous sales and distribution activities of [redacted]'s agent. [redacted], [redacted] is engaged in a U.S. trade or business.

Discussion

Produce grown by [redacted] in Mexico on the [redacted] farm is shipped into the United States for sale by [redacted]. Title to the produce is never transferred to [redacted], but remains with [redacted] throughout the entire sequence of sales events until it is loaded FOB on the buyers truck at the [redacted] shipping dock in the United States.

The exclusive distribution agreement between [redacted] and [redacted] establishes the principal - agency relationship and specifies the obligations of each of the parties. All net sales proceeds are remitted by [redacted] to an account maintained by [redacted] in the United States at the [redacted] in [redacted], Arizona.

When personal property is sold within the United States the case law distinguishes between isolated or infrequent sales, which may not qualify as engaging in business and

regular and continuous sales activity in the United States, which does qualify as engaging in a trade or business.

In Linen Thread Company, Ltd. v. Commissioner, 14 T.C. 725 (1950) the issue was whether petitioner, a foreign corporation was engaged in a trade or business in the United States. Petitioner had made two isolated sales in the United States during 1943, but its U.S. office was used principally for collecting interest and dividends from U.S. investments.

The court found no business purpose to the sales but merely a tax purpose. However, the court stated even assuming a business purpose, the two isolated transactions did not constitute engaging in a trade or business. Citing Lewellyn v. Pittsburgh, B & L.E.R. Co., 222 Fed. 177 (3rd Cir. 1915), which defined the phrase "engaged in business" as conveying the idea of progression, continuity or sustained activity, the court noted that there was nothing of continuity or sustained activity in the two isolated sales transactions.

In Frank Handfield v. Commissioner, 23 T.C. 633 (1955) the issue was whether petitioner, a nonresident alien was engaged in business in the United States for his fiscal year ending July 31, 1949. The petitioner was a Canadian resident engaged in the manufacture of postal cards in Canada (as a sole proprietorship) during the entire 1949 fiscal year. Petitioner managed the business from his office in Montreal. Petitioner was present in the United States for 24 days during the fiscal year. Petitioner also employed a U.S. resident who was to monitor the vendors of the American News Company to insure the cards were properly displayed and retailed.

U.S. sales of the cards was effected by a contract between petitioner and the American News Company, Inc. The pertinent terms of the contract were as follows:

1. American News Company, Inc. would be the exclusive distributor of the cards in the United States.

2. American News was to be charged two cents per card.

3. Any cards not sold by petitioner could be returned to the manufacturer.

4. Transportation/freight costs for shipping the cards into the United States and for returning unsold cards to Canada were to be borne by the manufacturer.

Based on the record, the Tax Court found the relationship between petitioner and American News was one of principal-agent in the form of a contract of consignment. The principal reasons for the court's finding were:

1. American News was not obligated to buy any definite amount of petitioner's merchandise and it is obligated to account only for the merchandise which has been sold;

2. All unsold merchandise could be returned;

3. Petitioner will pay the transportation on the cards to and from Canada and give full credit for all cards unsold regardless of their condition;

4. The agreement controls the retail price; and it gives the American News the right to discontinue merchandising the cards.

It is well settled that activities of an agent are imputed to the principal for purposes of determining whether the principal is engaged in a U.S. trade or business. See e.g., Inez de Amodio, 34 T.C. 894 (1960), aff'd without deciding this issue, 299 F. 2d 623 (3rd Cir. 1962), John Casimir Lewenhaupt, 20 T.C. 151 (1953) aff'd per curiam, 221 F. 2d 227 (9th Cir. 1955), W.C. Johnston v. Commissioner, 24 T.C. 920 (1955).

There is no doubt that the activities of [redacted] on behalf of [redacted] are continual and regular, as produce shipped into the United States is sold and distributed by [redacted] for at least six months during the calendar year. Accordingly, as the funds from the sales are deposited in [redacted]' U.S. bank account, the presumption is that [redacted] is the principal and is engaged in business in the United States within the meaning of § 864(b).

Section 871(b) governs the taxation of a nonresident alien engaged in a U.S. trade or business during the taxable year. Generally, a nonresident alien is taxable on his taxable income which is effectively connected to that trade or business. For this purpose, gross income includes only that which is effectively connected within the meaning of § 864(c).

Section 864(c)(1)(A) provides that if a nonresident alien is engaged in a U.S. trade or business, the rules set forth in § 864(c)(2), (3), (4), (6) and (7) shall apply to determining what income is effectively connected to that business.

Section 864(c)(2) describes items of income that are "fixed and determinable annual or periodical" ("FDAP"). Sales proceeds (from the sale of produce) is not FDAP. See § 1.1441-2(a)(3).

Section 864(c)(3) treats all U.S. source income (within the meaning of §§ 861(a), 863(b) and 865) that is not FDAP as effectively connected income. Income derived from the sale in the United States of property, whether real or personal is not FDAP. [§ 1.1441-2(a)(3)].

Section 861(a)(6) applies solely to personal property which is purchased and sold, sourcing the income entirely within the country of sale.

Section 865(a), effective for transactions of nonresident aliens after March 18, 1986, provides the general rule that except as otherwise provided, income from the sale of personal property by a nonresident alien shall be foreign sourced.

Section 865(b) provides an "inventory exception" to the residence source rule of § 865(a). Section 865(b) provides that § 865 shall not apply to source sales of inventory property but the provisions of §§ 861(a)(6), 862(a)(6) and 863(b) shall apply. Section 865(i) defines "inventory property" as personal property described in § 1221(1).

Section 1.863(b) provides that income from the sale or exchange of inventory property [within the meaning of § 865(h)(1)] (sic), produced (in whole or in part) by the taxpayer without the United States and sold within the United States shall be treated as derived partly from sources within and partly from sourced without the United States.

Section 863(a) requires the allocation and apportionment of items of gross income, expenses, losses and deductions between U.S. and foreign sources under § 1.861-8.

Section 1.863-1(a) provides that items of gross income shall be allocated or apportioned to U.S. or foreign sources as provided in § 863(a); however see § 1.863-2 for an alternative method of determining the taxable income from sources within the United States in the case of items specified in § 1.863-2(d).

Section 1.863-2(d) applies to income from the sale of personal property produced (in whole or in part) by the taxpayer without and sold within the United States.

Section 1.861-8(f)(3)(ii) states the relationship of sections 861, 862, 863(a) and 863(b). Each of the four

provisions applies independently. Where a deduction has been allocated or apportioned under one of those four provisions, the deduction shall not again be allocated and apportioned to gross income under any of the other three provisions. However, two or more of these provisions may have to be applied at the same time to determine the proper allocation and apportionment of a deduction. The special rules under § 863(b) take precedence over the general rules of sections 861, 862 and 863(b).

Section 1.863-2 provides an alternative for determining U.S. source taxable income in the case of gross income derived from sources partly within and partly without the United States. Under this method the entire taxable income is first determined by deducting the expenses, losses, or other deductions properly apportioned or allocated to the gross income and a ratable part of any other expenses losses or deductions which cannot definitely be allocated to an item or class of gross income.

Income within the purview of § 863(b) is considered a statutory grouping of gross income under § 1.861-8. Thus, assuming expenses and other deductions are allowable to [redacted] under § 874, (see discussion of this below) the Service should treat § 863(b) income as the statutory grouping and all other income as the residual grouping under § 1.861-8. Assuming the § 871(d) election made by [redacted] is valid (see discussion of this below) § 871(d) income should be viewed as the statutory grouping and all other income as the residual grouping under § 1.861-8.

Section 1.863-3(b)(2) provides the taxable income from sources within the United States in the case of an item of income covered by § 863(b) shall be determined according to the examples set forth under this subparagraph. For such purposes, the deductions for personal exemptions shall not be taken into account but the special deductions of § 1.861-8(c) shall be taken into account.

Example 1 provides:

Where the manufacturer or producer regularly sells part of his output to wholly independent distributors or other selling concerns in such a way as to establish fairly an independent factory or production price -- or shows to the satisfaction of the district director (or, if applicable, the Director of International Operations) that such an independent factory or production price has been otherwise established -- unaffected by considerations of tax liability, and the selling or distributing branch or department of the business is located in a different country from that in which the factory is located or the production carried on, the

taxable income attributable to sources within the United States shall be computed by an accounting which treats the products as sold by the factory or productive department of the business to the distributing or selling department of the independent factory price so established. In all such cases the basis of the accounting shall be fully explained in a statement attached to the return for the taxable year.

Example 1 has been clarified in Notice 89-10, 1989-___ I.R.B. ____.

1. An IFP may be derived only from sales of the manufacturer or producer unless the taxpayer chooses to show that an IFP has been otherwise established.

Under Example (1), certain sales by the manufacturer or producer that establish fairly an IFP must be used to determine the division of income. (For purposes of this Notice, the term "manufacturer or producer" includes manufacturing or producing operations conducted by members of the same affiliated group.) An IFP may be otherwise established only if the manufacturer or producer makes a showing to that effect to the satisfaction of the Internal Revenue Service. Such a showing might be based, for example, on market prices, analysis of economic functions, or transactions of other taxpayers. Such other methods may not be used by the Service to determine the appropriate division of income between domestic and foreign sources under section 863(b) (except to the extent they are used to demonstrate that actual sales of the manufacturer or producer themselves establish an IFP). Thus, for example, sales of taxpayers that are not affiliated with the taxpayer making the sale under consideration may not be used to attempt to establish an IFP unless the taxpayer chooses to use them.

2, An IFP may be established only on the basis of sales "regularly" made to independent businesses of "part" of the "output" of the manufacturer or producer.

Under Example (1), an IFP may be established only if the manufacturer or producer "regularly sells part of his output" of the relevant product to wholly dependent distributors or other selling concerns. An IFP may not be established by sales that are sporadic and occasional, or by sales that represent an insubstantial part of the total output of the relevant product of the manufacturer or producer.

3. Sales used to establish an IFP must be to "distributors or other selling concerns".

Under section 1.863-3(b)(2), the purchaser in any sale used to establish an IFP must be a distributor or other

selling concern. The use of this language means that such purchaser must be a selling business with respect to the relevant product (or a product into which it is integrated or transformed). If the purchaser of the relevant product customarily retains it for its own use, and does not in turn sell the relevant product or a product into which the relevant product is integrated or transformed, such purchaser is not a distributor or other selling concern within the meaning of Example (1).

4. Such distributors or other selling concerns must be "wholly independent".

Sales to distributors or other selling concerns will not be considered in establishing an IFP unless such concerns are wholly independent from the manufacturer or producer. For this purpose, the selling concern will not be treated as wholly independent of the manufacturer or producer if the former controls, or is controlled by, the latter within the meaning of section 482. Such control may be direct or indirect, and may be legally enforceable or control in fact.

5. An IFP must be "fairly established".

Example (1) seeks to determine the income attributable to manufacturing or production, and to characterize such income as from sources within the country of manufacture or production. In order for sales to establish an IFP, therefore, they must reasonably reflect the income earned from manufacturing or production. Sales to independent distributors or other selling concerns in certain circumstances, as described below, will not reasonably reflect the income from manufacturing or production.

A. Significant non-production, income-generating activity.

Sales will not establish an IFP if income-generating activity of the taxpayer other than manufacturing or production activity with respect to sales of the relevant product is significant in relation to manufacturing or production. For this purpose, if expenses of the manufacturer or producer attributable to non-production, income-generating activity with respect to sales of the relevant product are significant in relation to the gross receipts from such sales, such activity ordinarily will be considered significant. In applying this principle, non-production, income-generating activities shall include marketing and selling activities (at any stage of distribution), and similar activities. Expenses that are not attributable to non-production, income-generating activities shall include transportation, duties, excise taxes, insurance

and similar expenses. (Such expenses must, however, be netted from the sales price to determine an IFP.) In addition, if expenses of the manufacturer or producer attributable to non-production, income-generating activity with respect to sales of the relevant product are significant in absolute amount (without regard to their relation to gross receipts), and the manufacturer or producer maintains a trademark with respect to the relevant product that has significant value, such activity ordinarily will be considered significant.

For purposes of determining expenses attributable to sales of the relevant product, the principles of section 1.861-8 shall apply. Such expenses may be allocated directly to sales income from the relevant product or to a class of sales income including sales income from the relevant product under the principles of that section. To the extent such expenses cannot be allocated to sales of the relevant product, such expenses shall be apportioned on the basis of gross receipts from such sales of the relevant product and of other products.

In the case of sales made with a foreign sales corporation acting as commission agent, the commission shall be treated as an expense relating to non-production, income-generating activity.

B. Different Geographic Markets.

As noted above, the goal of Example (1) is to establish an IFP that reasonably reflects income attributable to manufacturing or production. Sales made to independent distributors or other selling concerns in the country of manufacture or production that meet the other requirements noted above will generally accomplish this result. This will not be the case only if it can be demonstrated that (i) market conditions in the country of manufacture or production permit the taxpayer to earn a substantially higher profit margin from the sale of the relevant product than in the country of the sale to which Example (1) is being applied, and (ii) the taxpayer directly engages in substantial activity in connection with such sale in the country of sale that constitutes non-production, income-generating activity.

If a taxpayer produces goods in one country and exports them to two other countries, sales in one destination country will not establish an IFP with respect to sales in the other destination country if the two markets are materially different with respect to sales of the relevant product. Such a difference might arise, for example, because of the taxpayer's policy of selling to unrelated parties at the same level of distribution at a significantly lower price in a

particular market to establish or maintain market share. The determination of whether the two markets are materially different shall take into account the prices at which the relevant product is sold in the two markets to unrelated parties at the same level of distribution (whether or not by the manufacturer or producer), after adjustments for transportation, insurance, excise taxes, duties and similar expenses, and after translation into U.S. dollars (if necessary) at the spot rate for the relevant foreign currency in effect as of the date of the relevant sale.

C. Sales used to establish an IFP must be reasonably contemporaneous with the sales to which Example (1) is being applied.

Generally, a reasonably contemporaneous sale is one that occurs in the taxable year of the sale to which Example (1) applies or in the prior taxable year. However, significant price instability during the period between the time of the sale being used to establish an IFP and the time of the sale to which Example (1) is potentially applicable may indicate that the prior sale does not fairly establish an IFP. Such price instability may be shown by reference to sales to independent parties (whether or not made by the manufacturer or producer) at the same level of distribution during the relevant period.

6. The foregoing rules under Example (1) must be applied with reference to the group of products consisting of substantially similar products.

An IFP may be established only on the basis of sales of products that are substantially similar in physical characteristics, function, and price of sale to unrelated parties at the same level of distribution. The rules contained in this Notice must, therefore, be applied in relation to sales of such substantially similar products. For example, the principles set forth in paragraph 5.A., above (relating to non-production, income-generating activities), shall be applied by treating all such sales as a statutory grouping under section 1.861-8.

Example 2 covers the situation where an independent factory or production price has not been established. (See Temp. Reg. § 1.863-3T). Where an independent factory or production price has not been established under Example 1, the gross income derived from the sale of personal property produced by the taxpayer within a foreign country and sold within the United States is computed as follows: One Half of the gross amount shall be apportioned in accordance with the value of the taxpayer's property within the United States and within the Foreign country, the portion attributable to

sources within the United States is equal to one half the gross amount times the ratio of the value of the U.S. property to the total value of the U.S. and foreign country sites property. The remaining one half of the gross income shall be apportioned in accordance with the gross sales of the taxpayer within the United States and within the foreign country.

As stated previously, the U.S. source portion resulting from the § 863(b) computation is effectively connected income by virtue of § 864(c)(3). The foreign source portion is not considered income attributable to a U.S. office or other fixed place of business within the meaning of § 864(c)(4)(B). In that regard § 864(c)(5)(B) provides that income is not considered attributable to a U.S. office unless the office is a material factor in the production of the income. Additionally, even assuming the U.S. office of [redacted] is a material factor, the income generated is not one of the types enumerated in § 864(b)(4)(B) or (C) and therefore is not effectively connected income by virtue of § 864(c)(4)(A).

Issue

Should [redacted] be allowed deductions allocable to effectively connected gross income?

Answer

No, because [redacted] has failed to comply with the requirements of § 874 and the regulations thereunder. Additionally, under a draft notice of proposed rule making relating to the untimely filing of income tax returns by nonresident aliens and foreign corporations, [redacted]' filing of Form 1040 NR for calendar years [redacted] and [redacted] is not timely under the standards set forth in the draft of the proposed regulations.

Discussion

Section 1.874-1(a) provides a nonresident alien shall receive the benefits of the deductions and credits allowed only if he files or causes to be filed with the district director a true and accurate return of his total income received from U.S. sources. Paragraph (b) states that if a return is not filed the tax shall be collected on the basis of gross income, determined in accordance with § 1.871-7 but without regard to any deductions otherwise allowable.

In Blenheim Co., Ltd. v. Commissioner, 125 F. 2d 906 (4th Cir. 1942) the petitioner failed to file a Form 1120 in a timely manner and respondent was sustained in disallowing deductions and assessing income tax on gross income.

The pertinent facts were as follows: On June 15, 1935 petitioner filed a personal holding company surtax return on Form 1120H showing a net loss but providing no information on how the net loss was calculated. Extended efforts by the Commissioner to have petitioner file a Form 1120 voluntarily were unsuccessful. Finally a substitute return was prepared by the Commissioner in which no deductions were allowed. Shortly thereafter on May 18, 1935 a notice of deficiency was sent to petitioner based on the substitute return. On August 9, 1938, the petitioner filed a Form 1120 showing no tax due. This late return was not entirely accurate.

The court construed the statutory requirement of "filing or causing to be filed with the collector a true and accurate return" strictly. The court found Congress' intent clear. Congress conditioned its grant of deductions on the filing of true proper complete returns. The court also noted the Treasury regulations expressly provided that no deductions were allowable unless an accurate and complete return was filed, and the filing of the return by the Commissioner fixed the tax liability. (The return filed by the Commissioner, is today, the § 6020(b) return.)

The court stated it was not in favor of prescribing an absolute rule that whenever the Commissioner files a return for a foreign corporation the taxpayer is automatically denied the benefits of deductions and credits, but, the facts justified disallowance in this case.

In Ardburn Co., Limited v. Commissioner, 120 F. 2d 424 (4th Cir. 1941) the taxpayer attempted to file a return with a revenue agent who refused to accept the return and failed to advise the taxpayer where to file. Subsequently a substitute for return was filed by the Commissioner allowing no deductions. The taxpayer later filed a return at the proper IRS office.

The court held that, under those facts the taxpayer was entitled to the deductions as a matter of elementary justice. The court distinguished this from Blenheim stating... "that taxpayer should be allowed such deductions when, upon the assessment of a deficiency against him; he shows that prior to the assessment he attempted in good faith to file a return in which the deductions were claimed.

Based on the existing statute, regulations, case law nd the facts of this case, we believe it appropriate to issue the notice to tax the effectively connected income on a gross basis.

For your information, a final draft of proposed amendments to the regulations under §§ 874 and 882 is enclosed. It should be treated as confidential. Nothing in the draft would alter the conclusion, above.

Issue

Is the § 871(d) election valid for [redacted] or [redacted] and what are the consequences.

Answer

The [redacted] 1040NR was filed on or about [redacted], within the time prescribed by § 6511(a) as required under § 1.871-10(d)(1)(i). Therefore the election is valid.

Discussion

Section 1.871-10 allows a nonresident alien deriving U.S. source income from real property (which is held for the production of income) to elect to treat all the income as effectively connected. The election may be made only with respect to U.S. source income which is not otherwise effectively connected to a U.S. trade or business. Income from a triple net lease is non-effectively connected income. See Rev. Rul. 73-522, 1973-2 C.B. 226 and Evelyn M. L. Neil, 46 BTA 197 (1942). If an election has been properly made, pursuant to § 1.871-10, for a taxable year, the election remains in effect, unless properly revoked, for subsequent taxable years regardless of whether there is income from the property.

The election applies to all income from real property which is located in the United States and held for the production of income. See § 1.871-10(b) for a complete listing of the income covered.

Section 1.871-10(c) prescribes the effect of the election. The income which is the subject of the election is taxable under § 871(b). Thus the gross rentals are effectively connected income and no withholding is required under § 1441. See § 1441(c).

Penalties

You have proposed additions to tax as follows:

(1) § 6651(a) failure to file - no reasonable cause shown 25% of the tax for [redacted] and [redacted],

(2) § 6656(a) failure to make deposit of taxes - no reasonable cause shown - 10% of the amount of the underpayment,

(3) § 6661 substantial understatement penalty - 25% of the amount of underpayment,

(4) § 6653(a) Negligence penalty - 5% of the amount of the underpayment.

With regard to (2), above, § 6656(a) does not appear to a proper penalty to assess against the [redacted]'. That section relates to underpayment of deposits such as taxes withheld from, employees wages. I have discussed this briefly with Norlyn Miller (FTS 566-3273) who has jurisdiction over § 6656(a). You may want to consult with him further on this matter.

It may be appropriate to assess penalties for failure to pay estimated tax, based upon the tax shown on the [redacted]' returns as filed. I suggest you also discuss this with Mr. Miller.

Finally, you might consider assess failure to file penalties against [redacted] for not complying with § 6038A.